ISDA® Safe, Efficient Markets

Testimony of Scott O'Malia
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Committee on Agriculture
Subcommittee on Commodity Exchanges, Energy, and Credit
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Chairman Scott, Ranking Member Scott and Members of the Subcommittee. Thank you for the opportunity to testify today.

I would like to thank the Committee for holding this timely hearing to discuss the ramifications of the last two rule-sets associated with the Group of 20 (G-20) derivatives reforms – bank capital and liquidity rules, and margin requirements for non-cleared derivatives trades. Both will have a profound impact on derivatives end users.

The capital and liquidity rules, which are being developed by the Basel Committee on Banking Supervision, will be implemented through to 2019. The margin rules kick in from September this year, and will be fully phased in by 2020.

My testimony today will address these two important rules. I will explain the findings ISDA and its members have produced to determine the cost impact of individual capital rules, and will emphasize the need for a comprehensive cumulative impact assessment encompassing all elements of the bank capital and liquidity reforms. I will also provide a progress update on the implementation of the margin rules, and the steps ISDA is taking to help regulators and market participants comply with them in a cost-effective and transparent manner.

Executive Summary

Over the past six years, substantial progress has been made to ensure the financial system is more robust. The implementation of the Basel 2.5 and Basel III capital and liquidity reforms means that banks now hold more and better quality capital than ever before. The amount of common equity capital at the largest US banks has more than doubled since the crisis. Liquidity requirements are also being phased in to reduce reliance on short-term borrowing and bolster reserves of high-quality liquid assets.

This is on top of derivatives market structure reforms that have been introduced by the Commodity Futures Trading Commission (CFTC) and, to some extent, the Securities and Exchange Commission (SEC), which include swap dealer registration, data reporting, trading and clearing mandates. In addition, a resolution framework is now being put in place to manage and allow for the orderly resolution of a bank without the need for taxpayer assistance.

But while many aspects of the new rules have been finalized and are already implemented, core elements of the Basel reform agenda, such as the leverage ratio, net stable funding ratio (NSFR) and the Fundamental Review of the Trading Book (FRTB), are still evolving.

As it stands, these reforms look set to significantly increase costs for banks, and may negatively impact the liquidity of derivatives markets and the ability of banks to lend and provide crucial hedging products to corporate end users, pension funds and asset managers.

We are concerned that the overall effect of the different parts of the bank capital reform program is unknown, and it is our belief that regulators should undertake a cumulative impact assessment post haste. When it comes to the health of the global financial system and economy, I think the old tailor's saying holds true – measure twice, cut once.

At the moment, we are cutting our cloth in the dark. Given continuing concerns about economic growth and job creation, legislators, supervisors and market participants need to understand the cumulative effect of the regulatory changes before they are fully implemented so we can prevent any significant negative impact to the real economy.

ISDA has been working hard to understand the impact of the individual elements of the rules. Over the past year, we have conducted eight impact studies on new capital and liquidity measures. In each case, those studies have indicated sizeable increases in capital or funding requirements for banks, on top of the increases that have already occurred as part of Basel III.

There is literally no one who has any clear idea what the aggregate impact of each of these rules will be. So far, each new measure has been looked at in isolation, without considering how it will interact with other parts of the capital framework.

Significantly, ISDA's analysis shows the impact is not uniform across all banks, with certain business lines hit particularly hard. We therefore believe it is crucial that policy-makers not only view the final capital rules through the prism of the overall impact on capital levels, but also assess the effect on individual business lines.

That's because the impact of the new rules on individual business units or product areas could be disproportionate, and the difference between a bank choosing to stay the course or exit the business. One good example is the leverage ratio and its effect on client clearing businesses. As it stands, the rule fails to recognize the risk-reducing effect of initial margin posted by the customer. This has proved detrimental to the economics of client clearing and is in direct conflict with the G-20 goals to encourage central clearing of derivatives.

Having provided my high-level recommendations on the capital and liquidity rules, I'd now like to turn to the final rules regarding margin for non-cleared derivatives.

As I noted earlier, these rules will have a significant cost impact on non-cleared derivatives trades. According to analysis published by the Federal Reserve and the CFTC, the industry may have to set aside over $300 billion in initial margin to meet the requirements.

ISDA has worked closely with the market at a global level to prepare for implementation. I am proud to say ISDA and its members have accomplished a great deal.

First, we have developed a standard initial margin model called the ISDA SIMM that all participants can use to calculate initial margin requirements. In a bilateral setting, having a central resource that can do this and resolve any disputes over initial margin calls will be vitally useful for all counterparties.

Second, we've worked to draw up revised margin documentation that is compliant with the rules, and we're developing a protocol to allow market participants to make changes to their outstanding margin agreements as efficiently as possible. This is essential for all market participants to exchange margin in an orderly and legally compliant way.

Third, we have established a completely transparent and robust governance structure to allow for the necessary evolution of the model, providing both regulators and market participants the confidence that the model is appropriately updated and available for regulatory review and validation.

Despite these efforts, challenges remain. In particular, there are concerns about how the margin rules will work on a cross-border basis. The requirements were drawn up at a global level by the Basel Committee and the International Organization of Securities Commissions (IOSCO) before being implemented by national regulators. That's a process we support, and has meant the various national rules are largely consistent.

But differences do exist in the detail, in everything from scope of the products and entities covered by the rules to settlement times. This means it is vital that substituted compliance decisions are based on broad outcomes, rather than rule-by-rule comparisons with overseas requirements.

The deadline for implementation of the initial margin requirements for the largest banks (Phase I) is approaching on September 1, 2016. Following this date is the variation margin 'big bang' on March 1, 2017, which affects all market participants.

There are a few items that need to fall into place to ensure the market can move forward confidently with these last rules.

First, regulators need to send a clear signal that the ISDA SIMM is fit for purpose and banks can confidently begin to apply this model to comply with the September 2016 deadline.

Second, the CFTC must finalize its cross-border margin rules to ensure substituted compliance determinations can be made for overseas rules that achieve similar outcomes.

These substituted compliance decisions also should be taken quickly. Another three-year wait for a substituted compliance or equivalence determination, as happened with the US/EU central counterparty (CCP) equivalency standoff, will hobble cross-border trading and further contribute to the fragmentation of global derivatives markets.

I'd like to address each of these issues in more detail. Before I do, I would like to stress that ISDA supports the intention of the capital reforms to strengthen the resilience of the banking system. We also support the safe and efficient use of collateral to reduce risk in the bilateral derivatives market.

In fact, ISDA has worked with its members to drive this objective for most of its 31-year history. We've also worked closely with our members over the past three years to develop the infrastructure, technology and documentation to ensure the new margin rules for non-cleared derivatives can be implemented with minimum disruption to the market.

This is consistent with our mission statement: ISDA fosters safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products. In fact, our strategy statement was recently modified to emphasize the importance of ensuring a prudent and consistent regulatory capital and margin framework[1].

Since ISDA's inception, we have worked to reduce credit and legal risks in the derivatives market and to promote sound risk management practices and processes. This includes the development of the ISDA Master Agreement, the standard legal agreement for derivatives, as well as our work to ensure the enforceability of netting. We currently have more than 850 members in 67 countries. Over 40% of our members are buy-side firms.

While ISDA represents the full cross-section of the derivatives market, including banks, exchanges, CCPs, asset managers, pension funds and supranationals, I would like to focus on the impact the capital rules will have on the banking sector.

Banks play a hugely significant role in the US economy. They provide access to capital markets and underwrite debt and equity issuances to ensure companies can raise the financing they require to expand their businesses. They provide the hedging and risk management tools that enable US firms to export their goods and services worldwide.

They provide loans to companies large and small to ensure they have the capital they need to grow. According to recent figures from the Federal Reserve, banks currently have more than $2 trillion in commercial and industrial loans outstanding. To put that into context, it's roughly the same as the GDP of India. That translates into business investment, jobs and economic growth.

Banks also provide risk management services to those end-user companies, creating balance-sheet stability and allowing them to improve their planning. The certainty that hedging provides gives companies the confidence to invest in future growth and create new jobs.

[1] ISDA mission and strategy statement: http://www2.isda.org/about-isda/mission-statement/

Given the vital role that banks play in our economy, it's important they are safe and resilient. And, since the crisis, a huge amount of effort has gone into making sure that they are.

Banks now have to hold much higher levels of capital than before the crisis – and that capital is required to be of much higher quality, ensuring it is able to absorb losses. Banks have also had to introduce new capital conservation and countercyclical buffers, along with the implementation of a capital surcharge for systemically important banks. They now have to explicitly hold capital against the risk of a derivatives counterparty default, and they are in the process of rolling out new liquidity requirements that are meant to ensure they have a sufficient stock of assets to withstand a sudden shock in market liquidity.

According to the Federal Reserve, common equity capital at the largest eight US banks has more than doubled since 2008, representing an increase of nearly $500 billion[2]. Their stock of high-quality liquid assets has also increased considerably, rising by approximately two thirds.

While significant improvements have already been made to the capital framework, a number of other reforms are either in the consultation phase or have been finalized but not yet implemented. Given the increases in capital that have already occurred since the crisis, policy-makers have recently been at pains to stress that further refinements should not result in a significant rise in capital across the banking sector.

In recent months, that message has been given by the G-20[3], the Financial Stability Board (FSB)[4], the Group of Central Bank Governors and Heads of Supervision (GHOS)[5], and the Basel Committee itself[6].

ISDA entirely supports this stance. While changes were needed in the wake of the financial crisis to bolster the capital held by banks, it's important this capital is commensurate with risk. Asking banks to hold ever higher amounts of capital could strangle bank lending, their ability to underwrite debt and equity, and their willingness to provide hedging services to end users. An economy requires capital and investment to thrive. Choke off the supply of financing, and economic growth will be put at risk.

Unfortunately, recent studies by ISDA suggest that several new measures will result in increases in capital. While each of the increases on their own may not result in a significant increase in capital across the banking sector, they do have an impact on certain business lines that are important for end-user financing and hedging.

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[2] Federal Reserve Chair Janet L. Yellen, Before the Committee on Financial Services, U.S. House of Representatives, Washington, DC, November 4, 2015: http://www.federalreserve.gov/newsevents/testimony/yellen20151104a.htm

[3] G-20 Finance Ministers and Central Bank Governors Meeting, Shanghai, February 27, 2016: http://www.g20.utoronto.ca/2016/160227-finance-en.html

[4] FSB to G-20 Finance Ministers and Central Bank Governors, February 22, 2016: http://www.fsb.org/wp-content/uploads/FSB-Chair-letter-to-G20-Ministers-and-Governors-February-2016.pdf

[5] Basel Committee press release, January 11, 2016: http://www.bis.org/press/p160111.htm

[6] Basel Committee press release, March 24, 2016: http://www.bis.org/press/p160324.htm

Crucially, though, it's currently not possible to say for sure how much the new measures, in aggregate, will increase capital requirements across the banking sector. That's because an overall impact study has not been conducted on the full set of capital, liquidity and leverage rules. While the potential for such a study has been limited during the rule-development phase, we believe a comprehensive analysis is now possible and necessary in order to help regulators and policy-makers calibrate the rules at an appropriate level.

ISDA would like to highlight several areas that we believe warrant further attention.

Leverage Ratio

The central clearing of derivatives transactions is a key objective of the G-20 derivatives reforms and a central tenet of the Dodd-Frank Act. The leverage ratio is a non-risk based measure meant to complement risk-based bank capital requirements, and is designed to act as a backstop.

In its current form, however, the leverage ratio acts to disincentivize clearing. That's because it doesn't take client margin into account when determining the exposures banks face as a result of their client clearing businesses.

Senior figures in the regulatory community already recognise this. In December last year, Mark Carney, the Governor of the Bank of England, noted that the current stance of the leverage ratio makes clearing more challenging, and "increases concentration, reduces diversity and reduces financial stability for the system" [7]. Timothy Massad, Chairman of the CFTC, has also echoed these sentiments[8].

Properly segregated client cash collateral is not a source of leverage and risk exposure. However, as currently proposed, the rule would require firms to include these amounts in their calculations. This is unreasonable, as cash collateral mitigates risk. Strict rules exist to protect this collateral and ensure it cannot be used to fund the bank's own operations. Instead, it can only be used to further the customer's activities or resolve a customer default. As such, it acts to reduce the exposure related to a bank's clearing business by covering any losses that may be left by a defaulting client.

The failure of the leverage ratio to recognise the risk-mitigating effect of segregated client cash collateral could mean the amount of capital needed to support client clearing services increases considerably. The end result is that the economics of client clearing would make it extremely difficult for banks to provide this service and may cause them to pull out of the market, harming liquidity and limiting opportunities for end users. This perverse outcome runs counter to the objective set by the G-20, as implemented by Congress in the Dodd-Frank Act, to encourage central clearing.

ISDA has been drawing attention to this issue for some time, and the Basel Committee recently reopened the leverage ratio for consultation. As part of that consultation, the Basel Committee

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[7] *Risk*, December 8, 2015: http://www.risk.net/risk-magazine/news/2438242/carney-leverage-ratio-could-limit-clearing-benefits

[8] http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-31

said it would collect data to study the impact of the leverage ratio on client clearing, with a view to potentially recognising the exposure-reducing effect of initial margin posted by the client.

We welcome that development – although it is disappointing that the consultation will not consider the recognition of initial margin more broadly. We will work with members to provide the necessary data for this consultation. Clearing has become a significant part of the derivatives market, so it's incredibly important we get this measure right.

Trading Book Capital

The Basel Committee's FRTB is intended to overhaul trading book capital rules, replacing the mix of measures currently in place with a more coherent set of requirements. The changes were primarily targeted at improving coherence and consistency in the market risk framework. Market risk capital levels were raised significantly in the immediate aftermath of the crisis through a package of measures known as Basel 2.5. Raising capital further was not a stated objective of the FRTB.

Nonetheless, the Basel Committee has estimated the revised market risk standard would result in a weighted mean increase of approximately 40% in total market risk capital requirements. But that estimate is based on a recalibration of quantitative-impact-study data from an earlier version of the rules.

To better understand the effect, ISDA recently led an industry impact study based on data submitted by 21 banks. The industry results show that market risk capital will increase by at least 50% compared to current levels. However, this assumes all banks will receive internal model approval for all their trading desks. If all banks do not receive internal model approval for all trading desks, market risk capital would increase by 2.4 times. ISDA believes the end result will be somewhere in between.

Importantly, our study shows a massive cliff effect between standardized and internal models. If a particular desk were to lose regulatory approval to use internal models, capital requirements could immediately increase by multiple times. To give an example, losing internal model approval under the new rules would result in a 6.2 times increase in capital for FX desks and a 4.1 times increase for equity desks[9].

Let me put that into context. Both FX and equity desks are important for end-user hedging and financing. FX trades allow US companies operating or selling products in foreign countries to obtain financing in the US, which is typically more cost effective, and enable them to limit their exposure to foreign currency fluctuations. A sudden, overnight increase in capital requirements of between four and six times could stymie the ability of a bank to continue offering that service, at least in the short term. We believe these rules should be carefully reconsidered to prevent lasting harm to actors in the real economy. (Please see Annex I for a more in-depth consideration of the impact of the FRTB.)

[9] These numbers exclude the so-called residual risk add-on, non-modellable risk factors and diversification across risk classes under internal models

ISDA welcomes the extensive engagement the Basel Committee has had with the industry during the development phase of the trading book rules. We have proposed technical modifications and refinements throughout the process, and will continue to provide feedback during the monitoring phase.

Net Stable Funding Ratio

The NSFR is designed to ensure banks fund their activities with sufficiently stable sources of funding to avoid liquidity mismatches.

ISDA supports the intention of this rule. One of the issues raised by the financial crisis was the gap between short-term borrowings of banks versus their long-term lending. Even ahead of this rule coming into effect in January 2018, banks have significantly reduced their reliance on short-term wholesale financing[10].

Nonetheless, we are concerned about the impact of the NSFR on the derivatives business, and believe the rule as it stands will hinder the ability of end users to access hedging products.

In particular, the rule currently requires banks to hold extra stable funding equal to 20% of derivatives liabilities, without taking into account any margin posted. This measure was not offered for public notice and comment, and the impact was never studied. ISDA understands the need to capture contingent liquidity risks, but the rule in its current form is overly conservative and duplicates other measures that already capture contingent liquidity risks to some extent, such as the liquidity coverage ratio. We therefore believe the 20% blanket add-on should be replaced with something more risk sensitive and properly calibrated.

We also are concerned by the lack of recognition of high quality liquid assets (HQLAs) received as margin. This means that US Treasuries, which count as cash equivalents in the liquidity coverage ratio, are treated as if they were illiquid assets with no funding value. We believe the NSFR should give funding benefit for HQLAs like US Treasuries.

The US banking agencies released a proposed rule earlier this week. We will review this rule and update the Committee of any new developments.

Internal Models

ISDA believes capital requirements should be globally consistent, coherent and proportionate to the risk of a given activity.

As a result, we're concerned about the regulatory shift away from internal models that have been utilized under supervision by prudential regulators. Internal models are the cornerstone of prudent risk management, as they enable banks to identify and appropriately measure risk across various dimensions.

[10] Federal Reserve Chair Janet L. Yellen, Before the Committee on Financial Services, U.S. House of Representatives, Washington, DC, November 4, 2015: http://www.federalreserve.gov/newsevents/testimony/yellen20151104a.htm

The move away from internal models has occurred in several areas: the recent decision by the Basel Committee to restrict the use of internal models for credit risk-weighted assets; the ditching of the advanced measurement approach for operational risk and the use of models for CVA; and the proposal to introduce capital floors, potentially on both the inputs and outputs of capital models.

Some regulators have highlighted complexity and variation in risk-weighted assets (RWAs) as a rationale for wanting to restrict the use of internal models. ISDA understands these concerns, but believes there are ways to address trepidation about RWA variability without eliminating internal models – through greater consistency and transparency of model inputs, or through ongoing benchmarking exercises that help regulators better understand the source of any differences in the way banks value their portfolios.

We need to strike the right balance between standardization and the ability of banks to maintain focus and expertise in identifying and appropriately measuring the underlying risks in their businesses.

Internal models are much more sensitive to risk and better align with how banks actually manage their business. In comparison, standardized models are relatively blunt, meaning the required capital charge for holding a particular asset might not adequately reflect its risk. This can lead to poor decision-making: a bank might choose to pull back from low-risk assets, counterparties or businesses where capital costs are relatively high. Conversely, they might opt to invest in higher-risk assets that appear attractive from a capital standpoint.

These issues were what prompted the Basel Committee to create incentives for the use of risk-sensitive internal models in the first place via Basel II. All models, standard or risk-based, have inherent weaknesses, but increasing transparency and applying benchmark testing can identify possible shortcomings. It simply isn't necessary to reverse course from Basel II and insist on an over-simplified standard model.

We believe, as a general point, that capital levels should reflect risk as closely as possible. A less risk-sensitive capital framework leads to the possibility of a misallocation of capital and an increase in systemic risk by encouraging herding behavior in the market. This raises the possibility of all market participants failing to identify emerging risks that do not necessarily exist today. Making decisions in a business that is intrinsically about taking and managing risk, based on a capital framework that is being made purposely less risk sensitive, creates its own hazards.

Along these lines, we were pleased to see the Committee recognize the value of internal models in its bill reauthorizing the Commodity Exchange Act[11]. Unfortunately, the CFTC's current approach for internal model approval in its proposed capital rule makes it impossible for entities that are not subsidiaries of US bank holding companies or SEC-registered security-based swap dealers to seek CFTC model approval (see Annex II). This highlights the need for further dialogue between the House, Senate, the CFTC and the SEC on this subject.

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[11] H.R. 2289, the Commodity End-User Relief Act

Overall, a non-risk-based capital framework is also likely to lead to a rise in total capital requirements across the bank – essentially because standardized models tend to be more conservative.

Margin for Non-cleared Derivatives

I would now like to turn to the margin rules.

As I mentioned in my introductory remarks, the implementation of margin rules for non-cleared derivatives from September will mark the completion of the last of the 2009-2011 G-20 derivatives reform objectives. From that date, the largest banks will be required to exchange initial and variation margin on their non-cleared derivatives trades. All other entities covered by the rules will be subject to variation margin requirements beginning next March, with initial margin obligations phased in over a four-year period.

ISDA has worked tirelessly for the past three years to prepare for implementation, and efforts have stepped up since US prudential regulators and the CFTC published their respective final rules at the end of last year.

ISDA Standard Initial Margin Model (ISDA SIMM)

A central part of this project is the development of the ISDA SIMM, which will be available for firms to use to calculate how much initial margin needs to be exchanged. The model is now finished from a design perspective. ISDA has been touring the globe in recent months, showing the methodology to regulators, alongside a transparent governance structure, in order to smooth the path to implementation. We have shared all the data that went into the development of this model, along with the calibration, the back-testing results and independent validation confirming the model meets the requirements of a one-tailed 99% confidence interval over a 10-day horizon.

We have found the US Prudential regulators,[12] the CFTC[13] and the European Supervisory Authorities' Joint Assessment Team[14] to be thoroughly engaged and knowledgeable. However, as the implementation date of September 1, 2016 draws closer, it is important that regulators move quickly to acknowledge that the ISDA SIMM is fit for service. Without the ISDA SIMM, firms are likely to utilize the fallback solution of standard tables, which were developed by the Basel Committee and IOSCO as the most conservative approach and are more costly.

Phase I banks have already begun their operational builds in preparation for the September 1, 2016 implementation date. Timely approval of the model at the firm-level is critical.

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[12] Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation

[13] The National Futures Association, which was recently designated by the CFTC to oversee the model application

[14] The Joint Assessment Team was established in early 2015, with the aim to assess the compliance of the different initial margin models to the requirements of the draft joint regulatory technical standards on the European Market Infrastructure Regulation and the Basel Committee-IOSCO framework: https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1381_-_annex_to_the_statement_by_steven_maijoor_esas_joint_committee_-_econ_hearing_14_september_2015.pdf

Credit Support Annex – facilitating the flow of margin

Another big focus has been preparing for the necessary revisions to ISDA credit support documentation in each jurisdiction. We're making very good progress here, and the first margin-compliant document was published earlier this month. ISDA is also developing a protocol to ensure the changes can be made to outstanding agreements as efficiently as possible.

There's still a lot that still needs to be done, but ISDA is working hard to deliver solutions in advance of the regulatory mandates.

There is one impediment that is standing in the way – the lack of final rules from the CFTC regarding the application of US rules abroad. Without these rules, we cannot complete the legal agreements to facilitate the exchange of collateral. This is important to meet the September 1, 2016 implementation deadline.

Finalizing the Cross-border Rules

While the margin rules were developed and agreed at a global level, the national proposals published by US, European and Japanese regulators initially contained a number of important differences. Variations even emerged between the proposals issued by US prudential regulators and the CFTC.

In letters to national authorities[15], ISDA highlighted those differences and suggested a more globally consistent approach. Ultimately, many of the biggest variations were ironed out in the final rules – but some still remain.

Let me first address the inconsistencies among international rules. Final rules from US prudential regulators and the CFTC require variation margin to be settled the day after execution of the trade, or T+1. This approach is more or less mirrored in European rules. In comparison, Japanese proposals require variation margin to be exchanged as soon as practically possible, while Singapore and Hong Kong regulators have proposed T+2 and T+3, respectively.

These differences matter, and the tighter time frame set by US and European regulators will make it practically difficult for US firms to trade with Asian counterparties.

There are also differences in the treatment of non-netting jurisdictions, the scope of instrument coverage, and the scope of applicability. These variations add to the complexity of complying with the rules in multiple jurisdictions.

Turning to the US rules, the CFTC's cross-border margin proposal is inconsistent with current CFTC cross-border guidance for swaps that are cleared and executed on a swap execution facility (SEF). Unlike the cross-border guidance, the CFTC cross-border margin proposal defines 'US person' as entities that have a "significant nexus" to the US, even if they are domiciled or organized outside the US. It also includes a different interpretation of non-US entities guaranteed

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[15] http://www2.isda.org/functional-areas/wgmr-implementation/

by a US person. This interpretation may lead to a single trade being subject to margin rules in multiple jurisdictions.

In addition, US prudential rules appear to recognize that a non-cleared swaps transaction arranged by personnel or agents of non-US banks located in the US would be excluded from mandatory margining. However, this contrasts with the position taken in the CFTC cross-border guidance, which imposes clearing, SEF-trading and reporting requirements on trades between a non-US swap dealer and a non-US person if those transactions are arranged, negotiated or executed in the US. This requirement is currently subject to no-action relief[16], but that relief expires in September. The CFTC should reconcile its cross-border guidance and the cross-border margin proposal with US prudential rules to ensure consistency for all swaps rules.

On a positive note, we appreciate that the CFTC allows for a substituted compliance regime in its cross-border margin proposal. Under that proposal, swap dealers and major swap participants would be able to post margin under foreign rules when trading with a non-US counterparty not guaranteed by a US person – but that would depend on those foreign rules being deemed comparable with US requirements. Market participants are concerned about the timing of these comparability determinations given the proximity of the implementation date. No determinations have been made so far with respect to margin rules, and the market has had no guidance on whether such determinations might be forthcoming.

Under the proposed cross-border margin rules, substituted compliance will be granted if the rules of foreign jurisdictions are consistent with the Basel Committee-IOSCO standards, which is positive. We are concerned, however, that the final rules will require an element-by-element analysis of overseas regimes.

ISDA believes that substituted compliance should be determined by whether a jurisdiction is consistent on an outcomes basis with the Basel Committee-IOSCO margin recommendation.

While US prudential regulators included requirements for cross-border trades in their final rules, the CFTC has yet to publish its final rule. With the new regime scheduled for implementation from September, it means there's just four months to issue the final rule and make substituted compliance decisions. Timing is critical as ISDA is developing the legal documentation that will assist market participants in determining whether they will fall within the scope of the margin rules. Without the CFTC's final cross-border margin rule, it will be difficult for ISDA to finalize these documents by the effective date of the rules.

We urge the CFTC to publish its final cross-border margin rule as soon as possible to maximize the possibility of substituted compliance decisions before the rules of other jurisdictions become effective.

Conclusion

To sum up, banks today are significantly stronger and more resilient than they were before the crisis. Capital levels have already increased significantly. But a balance needs to be struck

[16] CFTC Letter No. 15-48: http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/15-48.pdf

between making banks ever stronger by layering on additional capital and encouraging them to lend and facilitate hedging transactions.

As the commissioner of the Japanese Financial Services Agency, Nobuchika Mori, said at ISDA's annual general meeting in Tokyo earlier this month:

"We had better think carefully whether thick walls are enough to attain our dual goal of financial stability and growth. The Japanese heavy battleships *Yamato* and *Musashi* had the thickest walls, but we know that they were not resilient against air power. Instead of blindly trusting the thickness of the walls, we need to assess and strengthen the entire framework of prudential regulatory and supervisory policy."[17]

Global regulatory bodies have recognized this fact, and have called for further refinements to the capital framework to be made without significantly increasing capital across the banking sector.

However, ISDA studies have shown that new requirements will result in higher capital levels. How much is too much? At what point is the balance overly skewed in one direction, to the detriment of growth?

At the moment, no one knows.

ISDA believes a comprehensive impact study is necessary in order to provide regulators the information they need to make this decision. That study should cover all facets of the regulatory framework and consider the impact on all derivatives counterparties to ensure regulators are fully aware of the implications of further change.

Finally, ISDA is doing all it can to ensure the infrastructure, systems and documentation are in place to facilitate implementation of new margining requirements from September. But we remain concerned about cross-border implications. It is vital the substituted compliance framework is based on broad outcomes, rather than a line-by-line comparison of national rule-sets. We also urge the CFTC to issue its final rules as soon as possible.

I would like to close by expressing my sincere appreciation of the Committee's work and its commitment to exploring the impact of Dodd-Frank implementation through these hearings.

Thank you.

[17] Keynote address "From static regulation to dynamic supervision" by Nobuchika Mori, Commissioner, Financial Services Agency, Japan at ISDA's 31st Annual General Meeting, Tokyo, April 13, 2016: http://www2.isda.org/attachment/ODI5OQ==/JFSA%20Speech.pdf

ANNEX I

derivatiViews
From the executive office of ISDA

<u>FRTB: One Piece of the Capital Puzzle</u>[18]

With any jigsaw puzzle, it takes time before the full picture starts to become visible. Look at any single piece in isolation, and the picture is unrecognizable. Slot several of the pieces into place, and the image slowly starts to take shape.

A comparison of sorts can be made with the package of capital, leverage and liquidity reforms being introduced by the Basel Committee on Banking Supervision. The Group of 20 (G-20) has set out the picture it wants to end up with: a Basel III framework with an increase in the level and quality of capital banks must hold compared with the pre-crisis Basel II.
But the G-20 has also decreed that any work to refine and calibrate elements of the Basel III rules prior to their finalization and implementation should be made without further significantly increasing overall capital requirements across the banking sector. This is where it's hard to see how the pieces come together.

The latest segment of the capital jigsaw to be slotted into place is the Fundamental Review of the Trading Book (FRTB), an initiative to overhaul market risk requirements. In its January publication of the final FRTB framework, the Basel Committee estimated the revised standard would result in a weighted mean increase of approximately 40% in total market risk capital requirements. That estimate, though, was based on a recalibration of quantitative-impact-study data from an earlier version of the rules.

As a result, ISDA decided to lead an additional industry study [2] based on data from 21 banks to determine the impact of the final requirements – and the results were unveiled at ISDA's 31st annual general meeting in Tokyo last week.

The study shows an overall increase in market risk capital of between 1.5 and 2.4 times compared to current market risk capital. The lowest estimate of 1.5 times assumes all banks will receive internal model approval for all desks. If all banks fail the internal model tests for all trading desks, market risk capital would increase by 2.4 times. ISDA believes the end result will

[18] ISDA derivatiViews, April 21, 2016: https://isda.derivativiews.org/2016/04/21/frtb-one-piece-of-the-capital-puzzle/

be somewhere in between, but this will depend on two key variables: interpretation of rules on a so-called P&L attribution test and whether the calibration of capital floors applies to market risk.

The former is particularly important – and currently problematic. Under the FRTB, banks have to apply for regulatory approval to use internal models for each trading desk, with approval dependent on passing a P&L attribution test (essentially comparing internal capital systems with front-office models). But there is currently a lack of clarity over how this test will work in practice, while banks have not had time to develop the infrastructure that would enable them to produce the data required for the test.

Without more certainty on the methodology, and without knowing whether or at what level capital floors will be set, it is difficult to accurately estimate the ultimate impact. But it is unlikely all banks will receive internal model approval for all desks, meaning the end result may be closer to 2.4 times than 1.5 times.

Crucially, the study shows the final FRTB framework hasn't eliminated a cliff effect between standardized and internal models. If a particular desk loses model approval, capital requirements could immediately increase by multiple times. This had been something the Basel Committee had wanted to eliminate.

The FX and equity markets are most affected. Losing internal model approval under the new rules would result in a 6.2 times increase in capital for FX desks and a 4.1 times increase for equity desks[19].

These are big increases, and come on top of the jump in capital requirements already envisaged in Basel III. The question is whether this single piece of the jigsaw suggests the final picture will be out of line with what the G-20 expects. To put it more simply, will this piece, when combined with other changes in the capital framework, ultimately result in further significant increases in capital across the banking sector? The honest answer is that no one knows.

We do, however, know that large increases in capital could mean certain business lines end up becoming uneconomic. This could severely affect the ability of banks to provide risk management services and reduce the availability of financing for borrowers. At a time when some jurisdictions are increasingly focused on initiatives to generate and sustain economic growth, that's a concern.

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[19] These numbers exclude the so-called residual risk add-on, non-modellable risk factors and diversification across risk classes under internal models

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Summary of the industry study on the final FRTB rules[20]

FRTB QIS4 Refresh - Spotlight

ISDA gfma IIF

- Significant step in right direction – Highlights:
  - SA methodology overall capital charge is 2.4x compared to current market risk capital (QIS4: 4.2x); and
  - Residual risk add on in standard rules has reduced to 6% (QIS4: 49%) of total SA capital.
- NMRF remains a big component of internal models approach capital charge 30% (QIS4: 29%)
- Cliff effect between standard rules and internal models remains because:
  - Banks were asked to assume most desks obtain model approvals in the QIS instructions. In reality most banks are likely to lose model approval for a number of desks due to stringent tests;
  - Capital floors based on some percentage of standardised approach will be imposed; and
  - Cliff effect between the IMA and SA varies materially between and within risk classes, which may result in significant reallocation of capital and business activity.

	SA to IMA*
Interest rate risk	5.0
Credit spread risk	2.0
Equity risk	4.1
Commodity risk	2.9
Foreign exchange risk	6.2

*SA excluding residual risk add on & IMA excluding NMRF

*Results based on data contributed by 21 banks, refreshing earlier QIS4 analysis based on final FRTB rules

- Charges on securitization products improved in the final text, however, when looking at capital for the securitization portfolio including hedges, we see a significant increase in capital versus current levels.
- The results of P&L Attribution test and the calibration of the capital floor based on standard rules need to be considered to assess the full capital impact and how the change will translate to bank business models.

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20 http://www2.isda.org/attachment/ODM0OA==/QIS4%202015%20%20FRTB%20Refresh%20Report_Spotlight__FINAL.pdf

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ANNEX II

ISDA supports the Committee in recognizing the value of internal models in its bill reauthorizing the Commodity Exchange Act[21]. Under the CFTC's proposed capital rule, non-bank swap dealers that are subsidiaries of an entity with capital models approved by the Federal Reserve or SEC can seek CFTC approval of such internal models to calculate their related CFTC capital requirements.

Unfortunately, this approach leaves some ISDA members with no ability to seek CFTC model approval to calculate regulatory capital requirements. Specifically, those members that are neither a subsidiary of a US bank holding company nor an SEC-registered security-based swap dealer will be unable to seek CFTC model approval. This holds true for swap dealers that are subsidiaries of non-US financial institutions subject to robust home-country prudential regulation in a jurisdiction that is a member of the G-20 or a member of the Basel Committee.

Without an approved model, a swap dealer will be required to use a rigid standardized approach to calculate capital and margin requirements. The significantly higher costs associated with the standardized approach would make continued swap activity severely cost-prohibitive. The significant cost increase will result in higher costs for end users and create an unlevel playing field among dealers engaged in the same business, in the same markets, with the same customers. We do not believe that an aim of the Dodd-Frank Act was to cause significantly higher costs for end users, or for regulators to pick winners and losers among swap dealers and major swap participants. Nonetheless, these are the likely outcomes if model approval is unduly restricted.

We understand there has been a productive dialogue between the CFTC, SEC and market participants on these issues and we encourage it to continue. ISDA also appreciates that the House and Senate CFTC reauthorization bills provide for consultation between regulators on models, and authorize non-bank swap dealers to use comparable models to the extent bank swap dealers use an approved model.

[21] H.R. 2289, the Commodity End-User Relief Act